Understanding risk

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While few people enjoy taking risks, they're a normal part of investing and some risk serves a valuable purpose. If you didn't accept some risk, you wouldn't have the potential to achieve higher returns. However, it's important to ensure you're not taking on unnecessary risk. The goal is to determine what level of risk you're comfortable accepting and then balance it with the risk necessary to achieve your long-term goals.

What is risk?

Risk in the investment world is usually associated with market volatility. A commonly used phrase is, "Risk and return go hand in hand," meaning the higher the return potential, the more volatility you must be willing to accept. Markets never move in a straight line — they experience ups and downs.

Although the stock market has averaged about a 10% annual return since 1937, it has returned 5% to 15% only 16 times, and it has returned between 8% and 12% in a single year only five times. The market has had about three times as many up years (65) as down years (21), serving as a reward to long-term investors who can handle shorter-term volatility.

Range of returns in the S&P 500

1937–2022

Years with returns:	
Greater than 45%	1
Between 30% and 45%	14
Between 15% and 30%	28
Between 5% and 15%	16
Between -5% and 5%	11
Between -15% and -5%	11
Between -30% and -15%	3
Worse than -30%	2

Source: Morningstar Direct. Annual return of the S&P 500 TR USD Index, which includes dividends. An index is unmanaged and is not meant to depict an actual investment. Returns do not include the impacts of trading, liquidity, costs, fees or taxes a client can experience when investing, which would lower performance results. Past performance does not guarantee future results.

Risk is more than just volatility

Over time, you'll face many types of investment risk, such as interest rate risk, credit risk, economic risk and currency risk. Investors, meanwhile, often define risk as the potential for loss.

At its most basic level, risk refers to uncertainty and is much broader than volatility and the potential for (and size of) losses. Perhaps the biggest risk you may face is not reaching your financial goals. For example, a portfolio that is all in cash may have little, if any, volatility, but it also won't provide any growth potential or inflation protection. For retirees, not keeping up with inflation, or not having the right withdrawal strategy, can lead to another major risk: the risk of outliving their money. Ultimately, the key is to determine what level of risk is appropriate to help you achieve your financial goals.

The balancing act

The next step is really a balancing act, since there sometimes can be a discrepancy between how much risk you are comfortable taking and how much you actually have to take to achieve your goals. This is where you may need to make some important decisions. Your financial advisor can help you build a portfolio that balances your risk tolerance, capacity for risk, and the risk you're required to take with your financial goals.

For example, suppose you want to retire at age 55, and you have a low risk tolerance. However, your financial advisor estimates that to accomplish this goal, you'll need a higher return, resulting in a higher degree of portfolio volatility. In this case, you may have several choices, including working longer, saving more or accepting a higher degree of volatility. While this is a personal choice, by better understanding your goals and the risks associated with achieving them, you can make a more informed decision.

Determining the right risk level

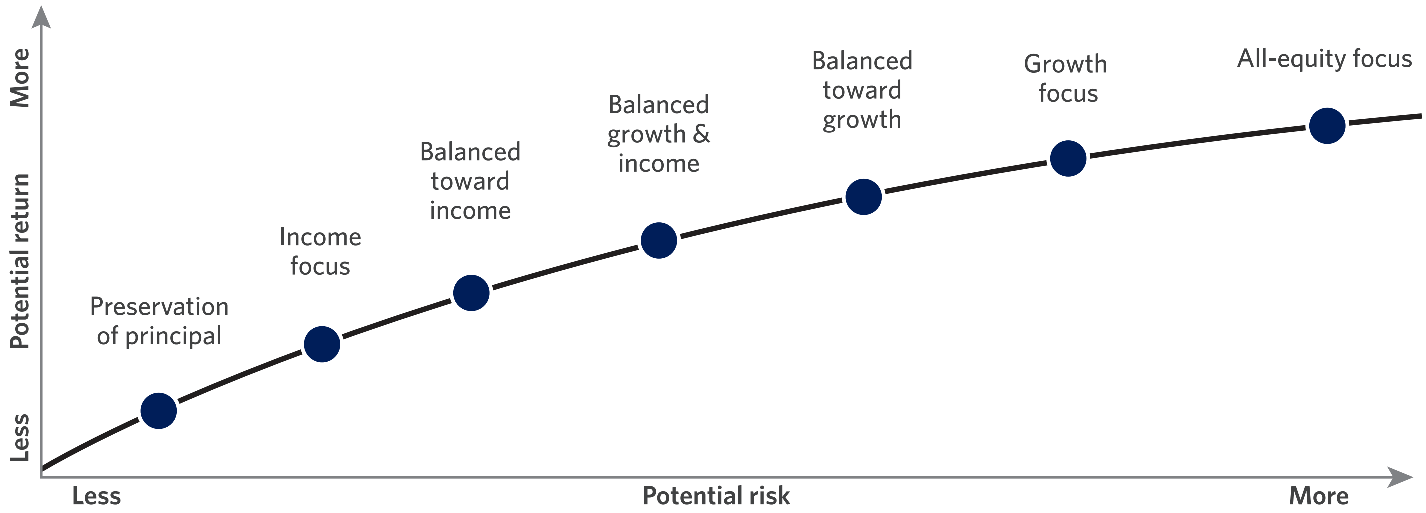
While risk may come in many forms, the process of determining what level of risk is appropriate covers three main areas:

- **Risk tolerance**
  This refers to your willingness or comfort level with taking risk. Typically, you'll be asked to complete a questionnaire that's used to gauge how you might react to risk in different situations. Gauging risk tolerance and your potential behavior is important because it's unlikely you'll reach your long-term goals if you abandon your strategy during inevitable short-term market declines.

- **Risk capacity**
  While risk tolerance refers to your comfort with risk, risk capacity considers your ability to handle risk. Your investment time horizon is often one of the biggest factors in determining your risk capacity. For example, if you're younger and preparing for retirement, you have a long time to make up for potential declines and could reasonably handle more volatility. However, if you're retired, your ability to handle stock market declines is likely smaller. Other items, such as income needs, may influence your risk capacity. For example, retirees relying on their portfolios for a large portion of their incomes may not be able to handle as much volatility as those who have more discretionary income and are not as reliant on their portfolios for their retirement needs.

- **Required risk**
  This refers to the level of risk required to achieve your investment goals. In the chart on Page 3, the higher the return needed to reach your goals, the more potential risk you'll need to take to achieve them. As you discuss your goals with your Edward Jones financial advisor, you can determine which portfolio objective aligns with the return you need.

Trade-off between risk and return



Risk, your emotions and your success

Typically, what prevents most investors from reaching their goals is not market volatility itself, but their reaction to this volatility. Investing based on emotions can often lead to one lasting emotion: disappointment. For example, the average investor's equity investments performed much worse than the S&P 500, as shown on the right. It's not because people owned the "wrong investments," but because they chased performance, buying when stocks were up and then selling when they dropped in value.

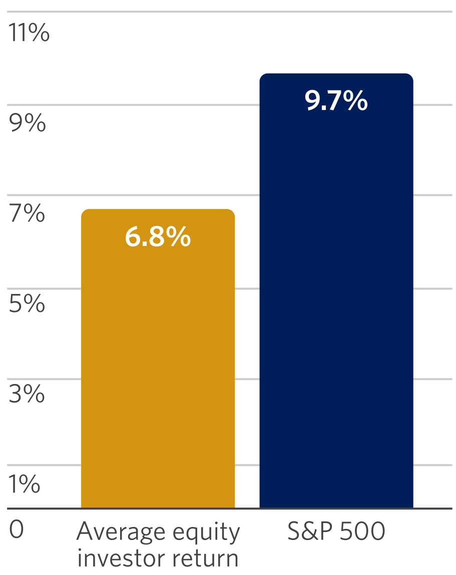
Understanding your comfort level with risk can only make you a better investor and perhaps avoid some of these pitfalls. By knowing your risk tolerance in advance, you can better control your emotions and stick to your long-term strategy during the inevitable market corrections along the way.

Action for investors

It's important to discuss with your financial advisor your goals and the amount of risk you're willing to take to reach them. You may need to make some difficult decisions. But ultimately, these decisions may help you avoid the biggest risk you face: not reaching your financial goals.

Chasing performance leads to underperformance

Average return per year



Source: "Quantitative Analysis of Investor Behavior, 2023," DALBAR, Inc. Annualized return for the past 30 years ending 12/31/2022. The S&P 500 is represented by the S&P 500 TR USD Index. An index is unmanaged and is not meant to depict an actual investment. Total returns include reinvested dividends. This study was conducted by an independent third party, DALBAR, Inc. A research firm specializing in financial services, DALBAR is not associated with Edward Jones. Past performance does not guarantee future results.

